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Income Tax Aspects of Partnership Operation[†]

By JOHN S. CRAWFORD*

As partnership affairs are conducted from day to day, the individual partners have transactions with the partnership and with each other. It is the income tax consequences of such transactions that are discussed here.

For purposes of illustration let us take a law partnership on the cash basis, reporting its income only as it is collected and claiming deductions when they are paid rather than when they are incurred. Its assets and liabilities are selected to demonstrate the different income tax consequences which may result from transactions involving various items.

These assets and liabilities are:

ASSETS:	Book Basis	Present Value
Cash	\$ 4,000	\$ 4,000
Accounts receivable and work in process.....	20,000
Buildings—net of depreciation reserve	50,000	60,000
Library and office equipment	1,000	5,000
Investments—stocks	5,000	15,000
	<u>\$60,000</u>	<u>\$104,000</u>
LIABILITIES AND CAPITAL:		
Accounts payable		\$ 4,000
Mortgage on building	\$30,000	30,000
Total liabilities	<u>\$30,000</u>	<u>\$34,000</u>
Partners' Capital [‡]		
A—50%	15,000	35,000
B—30%	9,000	21,000
C—20%	6,000	14,000
Total capital	<u>\$30,000</u>	<u>\$70,000</u>
	<u>\$60,000</u>	<u>\$104,000</u>

DISTRIBUTION OF PROPERTY TO A PARTNER

First, we shall examine the problems involved in the distribution of property by a partnership to a partner. Section 731² sets forth the general rules with respect to the extent of recognition of gain or loss on distributions.

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[‡]It is assumed that the individual partner's basis of his partnership interest is the same as the amount of his capital account on the partnership records.

²INT. REV. CODE OF 1954. All section numbers hereinafter cited refer to the INT. REV. CODE OF 1954.

Does the partnership realize a gain or loss upon the distribution of property to a partner? Section 731(b) provides: "No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money."

Does the partner realize a gain or loss upon the receipt of a distribution of property? The answer is sometimes "yes," sometimes "no."

Gain is not recognized except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. For example: If a partner with a basis of \$10,000 receives a distribution of \$8,000 in cash and property with a fair market value of \$3,000, no gain is recognized to him. If \$11,000 cash were distributed, gain would be recognized to the extent of \$1,000.³

Loss is not recognized upon a distribution except where the distribution is in liquidation of a partner's entire interest and where only money, unrealized receivables or appreciated inventory is distributed. If only these classes of assets are distributed, then the loss recognized is computed in the following manner: From the partner's basis in his partnership interest subtract (1) any money distributed to him, and (2) the basis to the distributee of any unrealized receivables and appreciated inventory. (This basis is usually the partnership's basis.)

For example: Partner *A* has a partnership interest in Partnership *ABC* with an adjusted basis to him of \$10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is \$5,000 cash and inventory with a basis to him (under section 732) of \$3,000. Partner *A* realizes a capital loss of \$2,000, which is recognized under section 731(a) (2).⁴

If, in the former example, *A* had received real property with an adjusted basis to the partnership of \$1,000, in addition to the other assets, no loss would have been recognized and the real property would have a basis to him of \$2,000.⁵

These then are the general rules: There is no gain or loss to the partnership on distribution. Gain to a partner is possible when cash is received. Loss to a partner is possible when amounts received in liquidation consist only of cash, unrealized receivables and appreciated inventory.

Section 731, however, provides for certain exceptions: "This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items)."⁶ Payments to a retiring or deceased partner are subject to special rules which are covered by Mr. Kinsey's article.⁷

To understand section 751 you must understand the objective which Congress was endeavoring to accomplish. Under the prior law some taxpayers were reducing their income taxes by some rather devious, but legal, devices.

³U.S. Treas. Reg. § 1.731-1(a) (1) (i) (1956).

⁴See also: U.S. Treas. Reg. § 1.731-1(a) (2) (ii) *Example (1)* (1956).

⁵*Id.* *Example (2)*.

⁶INT. REV. CODE OF 1954, § 731(c).

⁷Kinsey, *Income Tax Aspects of Partnership Dissolution*, 18 MONTANA L. REV. 167 (1957).

You are familiar with the use of the collapsible corporation by members of the motion picture industry to convert ordinary income into capital gains. In 1950 this use of a corporation was at least partially blocked. However, this result was still possible to a limited extent with partnerships. Unrealized increases in value could be created in the partnership; then the partnership interest, a capital asset, would be sold at a gain and reported as a long-term capital gain. The purchaser would dissolve the partnership and allocate the purchase price to the assets received on the dissolution.

In our example, A has a basis of \$15,000 in a partnership interest worth \$35,000. Under prior law it was possible that if he sold his partnership interest or withdrew assets other than accounts receivable, he could realize an ultimate capital gain of \$20,000 and realize no ordinary income. He would in effect convert his one-half of the \$20,000 fee income represented by accounts receivable to capital gain.

To avoid the above result, an exception to the general rule was provided where (1) the distribution was either of unrealized accounts receivable or appreciated inventory, or (2) where the partner received other assets in lieu of his interest in the unrealized receivables or appreciated inventory.

Unrealized receivables are defined as including, to the extent not previously included in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

- (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as received from the sale or exchange of property other than a capital asset, or
- (2) services rendered or to be rendered.⁹

Inventory items which have appreciated substantially in value are defined in the Code:

- (1) They must have a fair market value of 120 per cent or more of the adjusted basis to the partnership of such property, and
- (2) they must represent ten per cent or more of the fair market value of all partnership property other than money.⁹

Inventory items include what is normally considered as being inventory. Also included is any other property of the partnership which would not be considered a capital asset or property used in a trade or business held for over six months. These latter exceptions may be inventory items if they would have an inventory status in the hands of the selling or distributee partner.

Section 751(b) of the 1954 Code provides that certain distributions will be treated as sales or exchanges. To the extent that a partner receives, in a distribution, unrealized receivables or appreciated inventory in exchange for all or part of his interest in other partnership property, the transaction shall be considered as a sale or exchange. To the extent that a partner receives any distributed property (including money) other than unrealized receivables and appreciated inventory in exchange for all or a part of his interest in those items, such transaction shall be considered as a

⁹INT. REV. CODE OF 1954, § 751(c).

⁹*Id.* § 751(d).

sale or exchange of such property.¹⁰ These two provisions do not pertain to a distribution of property which the distributee contributed to the partnership or payments, described in section 736(a), to a retiring partner or successor in interest to a deceased partner.¹¹

We now discuss the transfer of the building to *A*. The building is worth \$60,000 but is subject to a \$30,000 mortgage. *A*'s adjusted basis of his partnership interest is \$15,000 plus his one half of the mortgage. Under the general rule, no gain would be realized, but here one of the exceptions is involved. By taking the building, *A* in effect gives up a portion of his interest in the unrealized receivables. He realizes a gain, then, to that extent. His interest in the receivables changes from one half to approximately one eighth as he has given up 30/35 of his partnership interest. We have assumed that his partnership ratio changed accordingly.

The actual computation of the gain is rather technical. Suffice to say that *A* would realize ordinary income of approximately \$7,500 by taking the building. The balance of the difference between the value of the building and his partnership interest apportioned to the building would not be subject to tax. The partnership would realize a gain to the extent that the value of the interest in the unrealized receivables given up by *A* exceeded the cost of the interest in the building given up by the partnership, as constituted after the transfer. This gain is allocated to the partners other than the distributee.¹²

A distribution of \$500 cash to *B* would be in the nature of an ordinary drawing. Generally it would result in no gain or loss to him. Some questions have been raised with regard to the disproportionate distribution of money. In that situation income might be realized. *B*'s share of the cash here is thirty per cent of \$4,000, or \$1,200, which is in excess of his drawings.

The transfer of \$1,000 accounts receivable to *C* may or may not result in a gain at the time of the assignment. If he takes it as a portion of his twenty per cent interest of \$4,000 in the accounts receivable, he realizes no income at the time of the assignment. He realizes ordinary income when he collects the account. If he relinquishes a portion of his interest in the other assets, the partnership realizes a gain to the extent of the value of the interest relinquished. The following example shows how the computation is made of the amount a partner receives in excess of his share: If *C* continues to have a twenty per cent interest in the \$19,000 of section 751 property remaining in the partnership after the distribution, only \$200 (\$4,000 minus \$3,800—twenty per cent of \$19,000) of the section 751 property received by him will be considered to be his share of such property. The remaining \$800 will be in excess of his share.¹³

What is the nature of the gain or loss when gain or loss is recognized? Section 731(a) provides that any gain or loss on a distribution shall be considered as a gain or loss from the sale or exchange of a partnership interest of the distributee partner. As a partnership interest is a capital asset, the

¹⁰U.S. Treas. Reg. § 1.751-1(b) (1) (1956).

¹¹INT. REV. CODE OF 1954, § 751(b) (2).

¹²U.S. Treas. Reg. § 1.751-1(b) (3) (1956).

¹³*Id.* § 1.751(b) (1) (ii).

general rule is that the gain or loss will be capital in nature.¹⁴ Gain attributable to the unrealized receivables and appreciated inventory is ordinary.

Is the capital gain or loss long-term or short-term? There is no specific provision governing the holding period to be attributed to the interest in the partnership deemed sold or exchanged. However, present case law has established that this period begins to run from the date the distributee acquired his interest in the partnership.¹⁵

PARTNER'S BASIS OF ASSETS RECEIVED ON DISTRIBUTION

In regard to distributions other than in liquidation of a partner's interest and other than money, the partner's basis is the property's adjusted basis to the partnership immediately before such distribution, except that such basis may not exceed the partner's basis in the partnership.¹⁶

If there were no unrealized receivables, the building would have a basis of \$45,000 to *A* computed as follows:

A's cost basis in partnership.....	\$15,000
Liability assumed	30,000
	\$45,000
Maximum basis allowed <i>A</i>	\$45,000

This is less than the \$50,000 basis to the partnership. However, the partnership has unrealized receivables upon which *A* may have realized a gain by taking the building. If so, we must adjust this basis for this gain. The basis then is increased approximately \$7,500.

The \$1,000 accounts receivable will have a zero basis in *C*'s hands if it is considered as being a portion of his share of the unrealized receivables. However, if it is considered as being in relinquishment of a portion of his interest in the other assets, he receives a basis to the extent of the gain realized by the partnership at the time of the assignment.

As regards distributions in complete liquidation of a partnership, the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is an amount equal to the adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction.¹⁷

Section 732(c) explains the allocation of basis as follows: First, apportion to unrealized receivables and inventory items an amount equal to the partnership basis. (In our hypothetical partnership this basis is zero.) Secondly, allocate to any other distributed property in proportion to its adjusted basis to the partnership.

A special election is available to a partner who acquired his partnership interest within two years prior to the date of distribution. The Secretary of the Treasury, by regulation, may require an adjustment under section 732(d) where the value of the property exceeds 110 per cent of the partnership basis. If you are dealing in appreciated property, check the

¹⁴INT. REV. CODE OF 1954, § 741.

¹⁵Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945); Allan S. Lehman, 7 T.C. 1088 (1946), *aff'd* Commissioner v. Lehman, 165 F.2d 383 (2d Cir. 1948). *Contra*, City Bank Farmer's Trust Co. v. United States, 47 F. Supp. 98 (Ct. Cl. 1942).

¹⁶INT. REV. CODE OF 1954, § 732(a).

¹⁷*Id.* § 732(b).

If the election is in effect, the partnership may adjust the basis of the remaining assets in accordance with the rules provided in section 755.

Section 735 provides for the gain or loss on the disposition of assets received. Unrealized receivables result in ordinary income when collected. On inventory items held less than five years, gain would be ordinary income when sold. If those items are held over five years gain or loss depends on the nature of the asset in the hands of the partner.

Other assets depend upon their nature in the partner's hands. For a capital asset, the holding period of the partnership is added to that of the partner to determine whether the asset has been held over six months.

In our hypothetical partnership, *A* would have a capital gain on the sale of the building. *C* would realize ordinary income upon collecting the accounts receivable.

TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

Under prior law it was not clear whether a partner was dealing as a stranger with his partnership or was dealing with himself to some extent. The new Code endeavors to clear this matter up.¹⁸

If a partner sells property to the partnership, he is taxed upon any gain realized and may deduct any loss, provided that—as to the loss—he does not own, actually or constructively, more than fifty per cent of the capital interest or profits interest in the partnership.

The partnership can now realize a gain on the sale of assets to a partner, and also losses—except where the partner owns more than fifty per cent of the partnership.

Guaranteed payments, such as for services rendered or for the use of capital, are considered by the partnership as if made to a stranger. However, such items are taxed to the partner in the year in which or with which the partnership's taxable year ends. Salary payments are not subject to social security taxes or withholding taxes.

Although, generally, gains and losses may now be recognized on sales between the partners and the partnership, a loss is not recognized where the sale is between the partnership and a partner owning more than fifty per cent of the capital interest or the profits interest in the partnership. The guaranteed payments are not a part of a profits interest.¹⁹ Losses in transactions between partnerships where the same persons own, directly or indirectly, more than fifty per cent each are not deductible.

Also, where the sale is of depreciable business property held more than six months between a partnership and a partner owning more than eighty per cent of the partnership, the gain, if any, is ordinary income to the party selling. The status in the hands of the transferee is determinative as to the nature of the gain.

Ownership of a capital or profits interest includes constructive ownership as provided in section 267(c). Thus an individual is deemed to own any interest in the partnership owned by his family. Where a husband, wife and son are the sole three partners of a partnership, each is deemed to own, for these purposes, 100 per cent of the capital and profits of the partnership.

¹⁸INT. REV. CODE OF 1954, § 707.

¹⁹U.S. Treas. Reg. § 1.707-1(c) (1956).

TRANSFER OF PARTNERSHIP INTEREST

As mentioned before, an interest in a partnership is a capital asset. Generally, therefore, a capital gain or loss results from a transfer thereof; except that ordinary income may result where there is a transfer of unrealized receivables or appreciated inventories.²⁰

Under the prior law, a capital gain resulted from the sale of a partnership interest irrespective of the underlying assets. Now the rules with respect to unrealized receivables and appreciated inventory items are much the same whether a sale or a distribution is involved. When such items exist, compute the tax costs before you advise your client to make the sale.

The basis of the transferee's interest will generally be what he paid for it. If he exchanges property for it, the normal rules of basis apply.

²⁰INT. REV. CODE OF 1954, § 751.